



*Michael C. Schlachter, CFA
Managing Director and Principal*

November 1, 2010

Dr. Louis Moret
Chair, Investment Policy Subcommittee
California Public Employees' Retirement System
400 Q Street
Sacramento, CA 95814

Re: Policy Revisions for Low Duration Fixed Income Program

Dear Dr. Moret:

You requested Wilshire's opinion with respect to the proposed revisions to the Statement of Investment Policy for the addition of the Dollar Denominated Fixed Income Low Liquidity Enhanced Return Fund (the "LLER Program") within the Low Duration Fixed Income Policy.

Recommendation

Wilshire recommends that the Policy Subcommittee adopt the revised policies as presented. However, the Subcommittee should note the additional liquidity and credit risks that the PERF will be taking on.

Background

Through this policy revision Staff is adding a third type of Low Duration Fixed Income portfolio, mainly for inclusion in the Synthetic Equity program that is jointly managed by Global Equity and Global Fixed Income Staff. The new portfolio created under this policy will allow for Staff to purchase illiquid securities at the very low end of the Investment Grade spectrum. These types of securities present significant opportunity, but also significant risk. Given that liquidity and credit were the two greatest risks during the "Credit Crisis" of 2008, this portfolio faces significant risk should that environment resurface. On the other hand, the Synthetic Equity program was approved by the Investment Committee specifically to take advantage of the opportunities presented by the recovery from this crisis, and so these risks should be understood.

We would also like to take this opportunity to reiterate our recommendation that CalPERS continue to add Staff in Fixed Income credit research. When buying lower-rated, illiquid securities, a thorough understanding of such securities is a necessity.

Given that we have been concerned for some time with the relative paucity of credit research resources within CalPERS, the addition of a portfolio such as this makes the need for research resources even more obvious.

We have reviewed the guidelines and limitations within the portfolio and do not have any specific objections. Some of the concentration limits (15% for AA and above issuers, 5% for below AA issuers) are far higher than would be preferable in a diversified fixed income portfolio, but can be appropriate in a small program such as this one.

Our only concern with the policy is with Section VII, where the policy states that “all security calculations will be performed at the time of purchase.” In practice, what this means is that CalPERS could end up with a portfolio that is significantly low-rated or more concentrated than the policy would seem to allow. CalPERS Staff could serially purchase AA or AAA securities that are subsequently downgraded, over and over, until the bulk of the portfolio is well below the BBB- floor. Since the policy applies only at time of purchase, there would be no violation of this policy if CalPERS credit research efforts failed to prevent the fund from investing in over-rated securities which subsequently were downgraded. Some possible options to prevent or mitigate this situation would be to have a freeze on purchases if the overall average rating fell below a certain point or to have Staff routinely report back on any securities that would be technically in violation of the policy after they have been purchased.

Should you require anything further or have any questions, please do not hesitate to contact us.

Sincerely,

A handwritten signature in black ink, appearing to read "Michael Smith", with a long horizontal flourish extending to the right.